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SUBJECT: NEEDED CENTRAL BANK RESTRUCTURING NOT FORTHCOMING

¶1. (SBU) Summary. El Salvador adopted the dollar as legal tender in 2001, but the Central Bank still maintains institutional vestiges of a monetary authority, issuing short-term and long-term debt and keeping on its balance sheet more than $700 million in government debt. Completing the institutional aspects of dollarization is a prerequisite to making the Central Bank an effective lender of last resort. Focusing instead on pension reform and maintaining the country's split sovereign investment grade credit rating, the Salvadoran Government is unlikely to take action on this issue, despite recommendations that it do so in the short term made by the International Monetary Fund (IMF) and U.S. Treasury's Office of Technical Assistance (OTA). We do not recommend further OTA assistance on this topic until the Salvadoran Government demonstrates tangible progress on the core recommendations first made in 2003 and effectively reinforced in 2006. End Summary.

¶2. (SBU) A July 2005 IMF report on El Salvador's 2004 Article IV Consultations noted that the country has not fully implemented the Monetary Integration Law that launched dollarization on January 1, 2001. In particular, Article 11 of the law requires the Ministry of Finance to assume outstanding Central Bank liabilities. Instead, the Central Bank continues to issue short-term debt to meet operational expenses, with $490 million currently outstanding, and it also issues long-term debt, with $191 million outstanding. The Central Bank also holds $704 million in illiquid long-term government bonds. Finally, it is the custodian of the banking sector's liquidity reserves, about $1.66 billion at year-end 2005, to protect against deposit runs--these reserves are also the Central Bank's foreign reserves. The Central Bank debt and the government debt held by the Central Bank are included in the IMF's estimate of total public debt as a percentage of GDP, 46.2 percent for 2005. Meanwhile, nonfinancial public debt for 2005 was estimated at 40 percent.

¶3. (SBU) The July 2005 IMF report indicated that Salvadoran officials had agreed to restructure the Central Bank's balance sheet as envisaged in the dollarization law through a plan approved by the Legislative Assembly in 2005 and carried out over the next 2-3 years. A December 2004 IMF Financial System Stability Assessment noted a similar commitment from the Salvadoran government. Such restructuring would improve transparency regarding government debt policy, but is also a prerequisite to converting the Central Bank into an effective lender of last resort for the financial sector. The banks have access only to their own liquidity reserves, and the Central Bank cannot serve as a lender of last resort--it had a negative liquidity mismatch of about $840 million by year-end 2005.

¶4. (SBU) Meanwhile, the Central Bank invited OTA to assess its operations in 2003, with an eye toward shoring up financial system vulnerabilities during a time of political uncertainty, and OTA made specific recommendations on cleaning up the Central Bank's balance sheet. A January 2006 OTA follow-up assessment found there had been no progress on Central Bank restructuring, and recommended again, among other things, gradually transferring the bank's debt to the central government. Doing so would improve transparency, but also give the Central Bank much-needed liquidity.

¶5. (SBU) Central Bank First Vice President Marta Evelyn de Rivera told econoff that the Central Bank and Ministry of Finance are preparing a medium-term plan to implement the OTA recommendations. She said in the short-term, however, the Central Bank and Ministry of Finance would begin to better coordinate their bond sales, and the Central Bank would look to retire some debt used to finance the Multisectoral Investment Bank (BMI), a state-owned development bank. She said she felt pressured to show some progress on these institutional issues in advance of IMF consultations scheduled for May. She cautioned, however, that dealing with the more difficult debt issues would take more study and more time.

¶6. (SBU) Manuel Rosales, the Ministry of Finance's Director of Public Credit and a top advisor within the government on debt policy, reinforced the Central Banks's message telling econoff recently that there were no plans to restructure the Central Bank's balance sheet in the near future. Rosales, who was well informed on conclusions of the IMF reports and the OTA assessments, said this was an inopportune time to deal with dollarization legacy issues. Highlighting the

work of an eminent persons group tasked by the government and the G-14 (a center-left legislative coalition) to study public debt issues, he stated categorically that there is no debt crisis in El Salvador, but there are a number of thorny issues that would challenge the government's ability to maintain debt at a sustainable level over the next few years. Dealing with those issues--rising pension costs and pressure to increase spending on health and education--will take priority over restructuring the Central Bank balance sheet, Rosales said.

¶7. (SBU) Mauricio Choussy, Fitch Ratings' managing director for Central America and a former Central Bank president, also told econoff that El Salvador is unlikely to tackle these Central Bank institutional issues in the near term. Moving the Central Bank debt to the Ministry of Finance would increase El Salvador's reported nonfinancial public debt. Choussy said that Moody's, another influential U.S.-based rating agency and the only one of the major agencies to give El Salvador an investment-grade rating, has focused on that measure of debt--not the financial public debt. He reported that Moody's is looking to downgrade El Salvador, but has been reluctant to do so without some change in the status quo--consolidating the balance sheet would give Moody's the excuse it needs. Choussy suggested there was more at stake here than the price of Salvadoran Government bonds. He cautioned that the banking sector in El Salvador has been able to access cheap capital overseas riding on the coattails of the government's investment-grade credit rating. The banks would see the interests rates they pay for offshore loans rise quickly, damaging their profitability, and cutting-off a useful source of finance for bank growth given falling savings rates in El Salvador.

¶8. (SBU) Roberto Rubio, a prominent center-left economist, also suggested that now would be an inopportune time to restructure the Central Bank balance sheet. In particular, he pointed to ballooning pension costs that would challenge the government's already tight fiscal position. Rubio, the most well-known of the economists named to the eminent persons group to study debt policy, suggested that the government must focus on a second generation of pension

reform and look for ways to increase government revenue, including new taxes such as a property tax.

¶9. (SBU) Comment: Government officials and independent economists believe that, contrary to advice offered by both the IMF and OTA, now is not the time to restructure the Central Bank balance sheet. Until the Central Bank balance sheet is restructured, the Central Bank is not a true lender of last resort, and that task would fall on the central government should a bank need more than its own prudential reserves maintained by the Central Bank. Completing the institutional aspects of dollarization would also make the process harder to reverse in El Salvador, providing a strong signal that the dollar is here to stay. OTA technical assistance has been useful in focusing attention on the issue, but we do not recommend further assistance until the Salvadoran Government demonstrates tangible progress on the core recommendations first made in 2003 and effectively reinforced in 2006. End Comment.

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